

Investment Consultant's Report

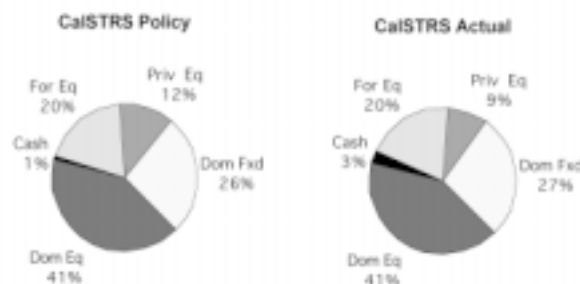


PENSION CONSULTING ALLIANCE, INC.

The CalSTRS investment portfolio increased by \$3.8 billion over the past twelve months ending with a value of \$100.5 billion on June 30, 2003. As highlighted below, the CalSTRS portfolio is broadly diversified, holding investments ranging from publicly-traded short-term bonds to privately-held partnerships. Clearly, the scale and breadth of investments make the management and oversight of these assets highly complex. In light of these factors, CalSTRS has been effective in using its resources in a cost-efficient manner to ensure that benefits continue to flow to CalSTRS participants.

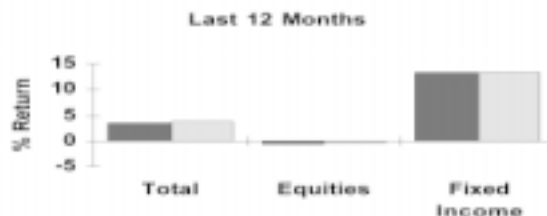
Investment Allocation

The most critical factor influencing overall investment performance is the allocation of the CalSTRS portfolio across major asset classes. The fiscal year-end report reflects asset allocation guidelines for the 2003-2004 fiscal year as a step towards long-term targets adopted in October of 2001 (see left pie chart). The portfolio's actual allocation is slightly different from policy. Domestic Debt and Cash are slightly over weighted while Private Equity is underweighted. Domestic Equity and Foreign Equity are in-line with their targets (see right pie chart).

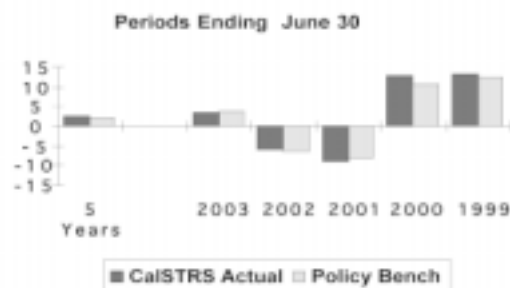


Investment Results

Over the last year, the CalSTRS investment portfolio produced an overall return of 3.4% ranking slightly below median among its large public pension fund peers¹ (top bar chart). The portfolio underperformed policy by approximately 40 basis points largely due to relative underperformance of the Fund's Alternative Investments asset class.² Benchmarking of this asset class is difficult in the short-term (less than five years) and should be discounted to some degree.



During the last three years, CalSTRS' portfolio generated a minus (4.0%) return, underperforming the policy benchmark (third quartile vs. peer funds). Over the last five years, the CalSTRS investment portfolio produced an average annual return of 2.5%, exceeding its policy benchmark by 40 basis points per year (bottom chart). However, these results are significantly below CalSTRS' actuarial rate of return. Successive one-year periods are shown as well. CalSTRS' portfolio has outperformed its policy benchmark in three of the last five one-year periods ending June 30, 2003.³



Pension Consulting Alliance, Inc.

¹ Per TUCS Universe for Public Funds with assets in excess of \$1 billion.

² The policy benchmark consists of passively managed asset class portfolios weighted by CalSTRS' policy allocations. The difference between actual results and the benchmark are due to two factors: i) deviations from policy and ii) active decisions on the part of CalSTRS and its investment managers.

³ CalSTRS' investment performance is calculated using a monthly internal rate of return and day-weighted cash flows. Periods longer than one month are geometrically linked. This method of return calculation complies with AIMR performance presentation standards.

Investments

Whether the stock market rebound of 2003 is the end of the storm or the eye of the storm, one thing is clear, the rebound helped the California State Teachers' Retirement System portfolio produce a positive return after two years of decline. The market value of the CalSTRS portfolio ended the fiscal year back above \$100 billion. Aggressive steps by the Teachers' Retirement Board and staff to rebalance the asset allocation near the lows of the U.S. equity market resulted in over one-half billion dollars of added return for the Teachers' Retirement Fund.

The fiscal year of 2002-2003 can be divided into three separate markets. For the first four months the markets continued the decline of the past two years. With the bear market growing long in the tooth, the next four months found the market building a bottom and a stop in the decline. For the final four months, the global equity markets staged a spectacular recovery gaining over 25 percent in short order.

This pattern was exemplified by the Fund's assets that declined to a low of \$84 billion, only to rebound by nearly \$20 billion in April, May and June. The gain was largely driven by the U.S. and Non-U.S. equity portfolios, which earned 19.0 percent and 15.9 percent respectively in the last quarter of the fiscal year. Over the entire year, the U.S. equity portfolio managed a gain of 1.0 percent while the Non-U.S. equity portfolio declined 5.1 percent.

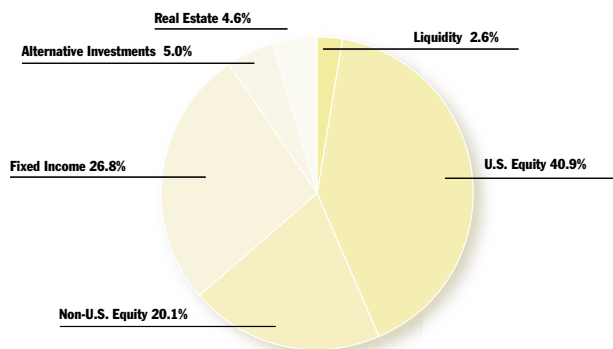
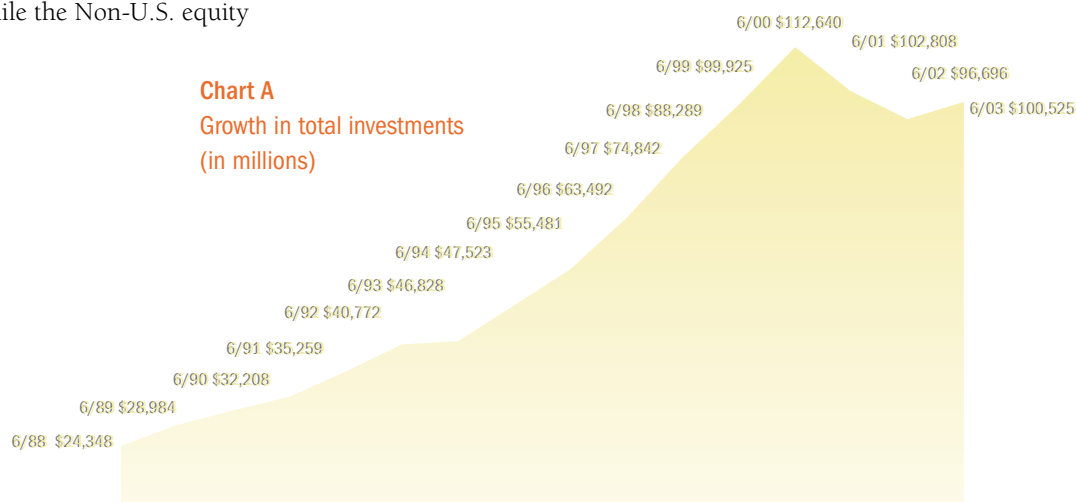
The fixed income portfolio benefited from the decline of interest rates to 40 year lows. At the start of the fiscal year, the Board approved a shift in the benchmark, which will reduce the risk to the portfolio if interest rates should rise. Overall, the fixed income portfolio generated a 13.2 percent return on the year.

The private illiquid asset classes of real estate and private equity performed within expectations. However, these are long-term asset classes and one-year performance is not very meaningful. The real estate portfolio gained 6.3 percent on the fiscal year. The private equity portfolio slightly outperformed its custom benchmark for the one and five year periods, while significantly underperforming it for the three years ended June 30, 2003.

OBJECTIVES

The core objectives of the Investment Management Plan remained unchanged. The primary objectives are set forth in the California Constitution and the California Education Code. The foremost objective is to provide for present and future benefit payments, then to diversify the assets, and finally, to reduce CalSTRS funding costs. Additionally, the Teachers' Retirement Board and staff strive to run the investment program in such a manner so as to maintain the trust of the participants and public.

Chart A
Growth in total investments
(in millions)



Asset Allocation (6/30/03)

Total investment portfolio of \$100.5 billion

Chart B

Growth in CalSTRS' returns (percent)

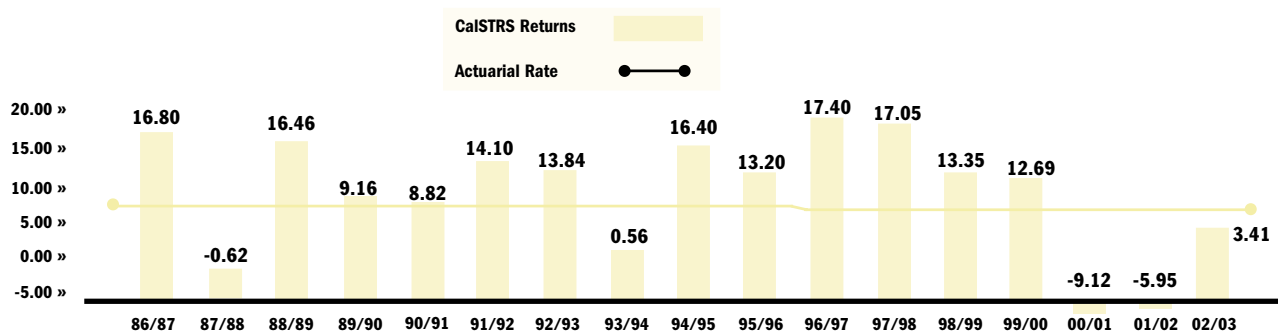


Chart C

Performance returns for major asset categories

Portfolio Type / Associated Indices	1 Yr	3 Yr	5 Yr	10 Yr
Total Fund	3.41%	-4.03 %	2.46%	7.48 %
US Equity	1.04	-10.51	-1.08	9.24
Russell 3000 *	0.69	-10.94	-1.44	9.56
Non-U.S. Equity	-5.06	-12.21	-2.05	4.07
MSCI All Country Free ex US (G) *	-4.28	-12.72	-2.97	3.06
MSCI Emerging Market Free *	6.80	-7.23	2.38	1.41
Fixed Income	13.19	11.02	7.67	7.93
US Debt Custom ⁽¹⁾	13.40	11.31	7.82	7.85
Lehman Brothers US Aggregate	10.41	10.08	7.54	7.21
Real Estate	6.33	10.38	12.21	11.27
Real Estate Custom ⁽²⁾	7.08	8.30	9.83	9.20
Alternative Investments	-3.64	-8.84	9.52	17.34
Alternative Investments Custom ⁽³⁾	-0.51	2.65	6.54	10.62
Liquidity	3.11	4.63	5.22	5.40
Salomon 3-Month Treasury Bill	1.41	3.15	3.89	4.40

* CalSTRS adopted tobacco free indices beginning 9/1/00

⁽¹⁾ Blend of Salomon LPE, LB US Aggregate and LB High Yield Cash Pay for the year ending 6/30/03 due to benchmark transition⁽²⁾ NCREIF after 7/1/97 and Institutional Property Consultants prior to 7/1/97; lagged 1 quarter⁽³⁾ Blend of the [Russell 3000 + 5% + 90 day T-Bill] after 4/1/99 and [CPI + 12%] prior to 4/1/99; lagged 1 quarter

FIXED INCOME

The fixed income assets within the CalSTRS investment portfolio include internally managed investment grade securities of approximately \$25.6 billion and externally managed high yield securities of approximately \$1.3 billion, which collectively are expected to generate a risk-adjusted return that is representative of the broad market-weighted universe of U.S. bonds. The strategic performance objective for the Fund's fixed income portfolios is to enhance the value of the total investment portfolio by means of a "top-down" approach in which incremental value is to be added through asset allocation, sector rotation and security selection. For the fiscal year ended June 30, 2003, the fixed income portfolios earned 13.2 percent, trailing the performance benchmark by 21 basis points.

Three other programs are managed within the Fixed Income Unit: Currency Hedging, Home Loan and Securities Lending.

Currency Hedging Program

The Currency Hedging Program has been designed to protect the value of the assets of the passively managed segment of the non-dollar equity portfolio by establishing controlled amounts of short currency positions in approved currencies (i.e., hedging), when there is the risk that the U.S. dollar may strengthen. Given the Fund's currency management philosophy, the strategic performance objective for the Currency Hedging Program is to mitigate the risk of the passively managed segment of the non-dollar equity portfolio as compared to the MSCI EAFE Index on an unhedged basis. This is to be accomplished by establishing hedges when there is the risk that the U.S. dollar may strengthen and by removing

them when there is widespread U.S. dollar weakness. Through June 30, 2003, the Currency Hedging Program has generated more than \$600 million in income, offsetting a corresponding decline in the non-dollar equity portfolio.

Home Loan Program

The CalSTRS Home Loan Program was established as a result of legislation in 1984, with a mandate to provide the opportunity for home ownership to qualified participants, while meeting the investment goals of the System by generating a mortgage investment asset. The CalSTRS Home Loan Program strives to offer borrowers a variety of mortgage programs that best meet their individual needs, while also providing "best in class" customer service to our borrowers — before, during, and after the mortgage loan process. The assets created by the Home Loan Program are purchased and managed as part of the mortgage allocation within the Fixed Income portfolio, or sold in the financial markets. As a result, the Home Loan Program is held to the same investment standard and compared to the same performance benchmark as the other mortgage related assets within the Fixed Income Portfolio. Currently, three loan programs are offered through participating Correspondent Lenders who generate approximately \$30 million in mortgage loans every month.

Securities Lending Program

The Securities Lending Program has been designed to enable the Fund to generate incremental income by making collateralized, low-risk, short-term loans, using a portion of the equity and fixed income assets held within the investment portfolio. The performance objective for the program is to earn lending income commensurate with: 1) the market demand for the

Chart D

Ten largest fixed income holdings as of June 30, 2003 (CalSTRS maintains a complete list of portfolio holdings)

Issue	Maturity Date	Interest Rate	Par	Market Value	Average Cost	Unrealized Gain/(Loss)
US TREASURY BONDS	15-Nov-06	3.500%	\$500,000,000	\$527,140,005	\$522,307,724	\$4,832,281
US TREASURY BONDS	15-Jul-06	7.000%	400,000,000	462,347,992	455,819,558	6,528,434
US TREASURY BONDS	15-Oct-06	6.500%	400,000,000	459,579,988	455,031,354	4,548,634
US TREASURY BONDS	28-Feb-05	1.500%	350,000,000	351,704,472	350,114,569	1,589,903
US TREASURY BONDS	15-Aug-19	8.125%	200,000,000	289,205,994	207,395,989	81,810,005
US TREASURY BONDS	15-Aug-07	3.250%	270,000,000	281,796,330	279,597,093	2,199,236
FEDERAL NATL MORTGAGE ASSN	15-Oct-06	4.375%	240,000,000	257,321,500	255,669,109	1,652,391
US TREASURY BONDS	31-Mar-05	1.625%	250,000,000	251,735,000	250,372,592	1,362,408
FEDERAL NATL MORTGAGE ASSN	15-Jan-10	7.250%	200,000,000	247,408,004	241,151,388	6,256,616
TENNESSEE VALLEY AUTHORITY	15-Mar-13	6.000%	200,000,000	234,212,020	205,913,182	28,298,838

securities made available for lending and 2) the return earned on the investment of cash collateral within the guidelines set forth by CalSTRS. For the fiscal year ended June 30, 2003, the Securities Lending Program earned approximately \$65 million in additional income for the Teachers' Retirement Fund.

Internal Equity Management

The objective for Internal Equity Management is to implement portions of the domestic equity allocation. The portfolios include an indexed portfolio and cash equitization program. The performance objective of the internally managed indexed portfolio is to closely track the return of the Russell 1000 ex-Tobacco Index. As of June 30, 2003 the portfolio had a market value of \$14.5 billion. The return of the portfolio for the fiscal year was 0.98 percent. The portfolio's return exceeded the benchmark by 0.11 percent for the period.

The Cash Equitization Program enables CalSTRS to "equitize" the excess cash being held by the domestic equity managers. The program provides a mechanism for the domestic equity allocation to remain close to the board-approved strategic asset allocation policy target. As of June 30, 2003, the program had a market value of \$116.6 million. The return of the program was 1.40 and -10.18 percent for the 1- and 3-year periods, respectively. The program outperformed its benchmark in each period by 1.15 and 1.02 percent, respectively.

ALTERNATIVE INVESTMENTS

The Alternative Investments asset class invests in the private equity universe. These investments involve companies that are not publicly traded and normally require active involvement by the external equity managers hired by CalSTRS. The vast majority of these investments are made through limited partnership portfolios, which consist of pools of investments.

During fiscal year 2002-03, CalSTRS made additional commitments of approximately \$594 million in this segment of the portfolio. Total commitments now amount to approximately \$9.0 billion. There are 120 partnerships and 11 co-investments in the Alternative Investment portfolio. At the end of the fiscal year, the total market value was \$5.1 billion, representing approximately 5.0 percent of the total CalSTRS portfolio. CalSTRS continues to increase its commitments in this area as a result of the allocation review completed at the end of June 1999. The Alternative Investment asset class has achieved annualized returns of -3.6, -8.84 and 9.52 percent, for the 1-, 3-, and 5-year periods respectively, lagged one quarter.

Credit Enhancement

CalSTRS has long-term credit ratings of AA+/Aaa/AAA by Standard and Poor's, Moody's Investors Service, and Fitch Inc., respectively. The ratings are utilized by issuers of municipal debt in California to assist in the issuance of variable rate municipal bonds. CalSTRS enters into agreements with a number of issuers of tax-exempt debt to provide the payment of principal and interest in the event of a non-payment and/or market support in the capital markets. In return, CalSTRS earns fee income for these commitments. Most of the transactions are supported by banks or bond insurers for repayment. As of June 30, 2003, the Credit Enhancement Program had commitments of approximately \$1.6 billion and fee income earned during the fiscal year was approximately \$5 million.

REAL ESTATE

CalSTRS portfolio of leveraged real estate assets is valued at \$4.6 billion. The real estate portfolio is comprised of 122 directly owned properties, nine joint venture relationships and investments in 15 opportunity funds. During the last fiscal year twelve assets were acquired, either fully owned by CalSTRS or with a joint venture partner, and five assets were sold. Real estate assets are 4.6 percent of the total fund with a 6 percent allocation. The direct property portfolio is diversified as to property type and geographic location. The largest component of the direct property sector is office buildings, with the largest weighting in the western region of the United States. During the current fiscal year a Leverage Program was implemented. Two debt strategies were executed: a \$750 million commercial mortgage-backed security transaction and a \$275 million net revolving line of credit. The CalSTRS real estate portfolio has achieved gross annualized returns of 6.33, 10.38 and 12.21 percent for the 1-, 3- and 5-year periods, respectively. CalSTRS return exceeded the NCREIF benchmark by 0.8, 1.8 and 2.0 percent for each of the 1-, 3- and 5-year periods.

Chart E

Ten largest equity holdings as of June 30, 2003 (CalSTRS maintains a complete list of portfolio holdings)

Issue	Shares	Market Value	Average Cost	Unrealized Gain/(Loss)
General Electric Co.	37,056,147	\$1,062,770,296	\$638,198,518	\$424,571,778
Pfizer Inc.	30,316,527	1,035,309,397	607,869,547	427,439,850
Microsoft Corp.	35,711,904	914,581,861	580,558,492	334,023,369
Citigroup Inc.	20,359,086	871,368,881	450,444,229	420,924,652
Exxon Mobil Corp.	24,106,799	865,675,152	547,420,564	318,254,588
Johnson & Johnson	11,615,303	600,511,165	368,685,909	231,825,256
Wal Mart Stores Inc.	10,958,722	588,154,610	250,898,212	337,256,398
Intel Corp.	26,777,672	556,547,135	348,877,896	207,669,239
Merck & Co Inc.	8,434,255	510,694,140	272,643,291	238,050,849
American International Group Inc.	9,029,337	498,238,816	295,373,470	202,865,345

EXTERNAL EQUITY MANAGEMENT

The Public Equity portfolio, which is comprised of both internally and externally managed portfolios, continued to be an important investment vehicle to the fund. In fiscal year 2002–03, this segment of the portfolio accounted for about 61.0 percent (or \$61.3 billion) of the total fund. Domestic Equity accounted for 40.9 percent of the total equity allocation, while International Equity accounted for the remaining 20.1 percent.

The External Equity portfolio is managed by 16 external domestic managers and 18 external international managers. Although the equity markets were extremely volatile, CalSTRS international active managers added value by outperforming their benchmark by 78 basis points; however, CalSTRS domestic active managers slightly underperformed their benchmark by 55 basis points.

CORPORATE GOVERNANCE

During the 2002–03 fiscal year, CalSTRS voted on a variety of proxy issues including financial, corporate governance and social issues. More than 6,900 votes were cast on proxy issues of corporations whose shares were owned in the Investment Portfolio. These proxy issues were presented on approximately 2,714 companies. The overall number of proxy issues decreased from 7,050 last year. The number of mergers/acquisitions reviewed decreased to less than 1 percent from 3 percent of all issues reviewed last year.

The major issues voted are summarized below:

1. Election of Directors: CalSTRS generally votes in favor of directors unless the proxy statement shows circumstances contrary to policy. Examples of such circumstances are: greater than 50 percent board representation by company executives, potential conflict of interest due to other directorships or employment, and classification of the company directors.

Number Voted: 2,632

For: 2,022

Against: 610

2. Selection of Auditors/Accountants: CalSTRS reviews votes for the independent auditors and accountants on a case-by-case basis.

Number Voted: 1,615

For: 650

Against: 965

3. Compensation Plans: (Stock Options, Incentive Stock Options, Employee Stock Purchase Plans, etc.) Corporations provide a variety of compensation plans to keep executives, employees and non-employee directors. A number of these plans provide for the issuance of long-term incentives to attract, reward and retain key employees. Compensation plans are evaluated based on CalSTRS Financial Responsibility Criteria.

Number Voted: 848

For: 303

Against: 545

4. Approve Merger/Acquisition-Management: CalSTRS generally votes in favor of the acquisition or merger of one company into another.

Number Voted: 67

For: 65

Against: 2

5. Corporate Actions/Corporate Governance Issues: These are issues related to spin-offs, stock issuance, stock splits and incorporation. CalSTRS votes these proposals on a case-by-case basis.

Number Voted: 153

For: 133

Against: 20

6. Other–Miscellaneous–Management: CalSTRS generally votes in favor of other miscellaneous business recommended by management, but issues are decided on a case-by-case basis.

Number Voted: 370

For: 269

Against: 101

CASH BALANCE BENEFIT PROGRAM

The Cash Balance Benefit Program contributions were invested into pooled funds from inception (February 1, 1997) through June 30, 2001. Sixty percent of the contributions were allocated to the S & P 500 portfolio and 40 percent to the Government Index portfolio. Beginning July 1, 2002, Cash Balance Benefit Program contributions are invested in the Teachers' Retirement Fund Excluding Private Equity (Alternative and Real Estate investments). The investment value of contributions as of June 30, 2003 is \$29.7 million. The rate of return for the Cash Balance Benefit Program for the fiscal year was 3.6 percent.

DEFINED BENEFIT SUPPLEMENT PROGRAM

The Defined Benefit Supplement Program contributions are invested in the Teachers' Retirement Fund Excluding Private Equity (Alternative and Real Estate investments). Contributions were first received in the Defined Benefit Supplement Program in January 2001. The investment value of those contributions as of June 30, 2003, is \$1.1 billion. Since the inception of the Defined Benefit Supplement Program, the annualized rate of return is -3.3 percent. The rate of return for the Defined Benefit Supplement Program for the fiscal year is 3.6 percent.

Chart F

Investment summary as of June 30, 2002, and for the year ended June 30, 2003 (dollars in millions)

Portfolio Type	June 30, 2002		June 30, 2003			
	Book Value	Market Value	Book Value	Market Value	% of Market Value	Net Market Change
US Equity	\$28,628	\$37,887	\$31,106	\$41,140	40.93%	\$3,253
Non-US Equity	21,972	21,220	21,354	20,171	20.07%	-1,049
Fixed Income	26,260	27,065	25,528	26,939	26.80%	-126
Alternative Investments	4,136	4,257	5,034	5,072	5.05%	815
Real Estate	5,210	5,034	4,779	4,579	4.55%	-455
Liquidity	1,233	1,233	2,624	2,624	2.61%	1,391
Total Portfolio	\$87,439	\$96,696	\$90,426	\$100,525	100.00%	\$3,829
Plus: Securities Lending Collateral		13,325		14,367		
Less: Accruals		181		-819		
Less: Cash & Cash Equivalent		65		156		
Total Investments*		\$109,775		\$115,555		

* State Teachers' Retirement Plan (see page 21 of this report)

Chart G

Schedule of fees July 1, 2002, through June 30, 2003 (dollars in thousands)

	Assets Under Management	Fees	Basis Points
Investment Managers' Fees:			
US Equity	\$ 25,871,056	\$ 21,682	8.4
Non-US Equity	20,170,520	28,971	14.4
Fixed Income	1,288,954	2,571	19.9
Alternative Investments	4,672,917	667	1.4
Real Estate	4,578,523	18,172	39.7
Total Investment Managers' Fees	\$56,581,970	\$72,063	12.7

Chart H

Broker commissions July 1, 2002, through June 30, 2003

Broker Name	Commission	Shares	Commission per Share
US Equity Transactions			
Goldman Sachs	\$818,950	30,382,470	\$0.027
Merrill Lynch Pierce Fenner & Smith Inc.	742,262	29,826,081	0.025
Morgan Stanley and Co, Inc	730,976	31,442,663	0.023
Investment Technology Group Inc.	702,590	34,671,001	0.020
Capital Institutional Services	558,617	12,652,616	0.044
CS First Boston Corporation	499,642	16,637,307	0.030
UBS Warburg LLC	436,237	12,520,653	0.035
Lehman Bros Inc.	422,965	12,491,862	0.034
Jackson Partners & Associates Inc	409,681	8,058,306	0.051
Salomon Smith Barney Inc	382,811	18,433,069	0.021
Other US Brokers	7,447,302	211,523,514	0.035
Total Commissions on US Equity Transactions	\$13,152,034	418,639,542	\$0.031
Non-US Equity Transactions			
Merrill Lynch	\$2,240,206	2,957,274,696	\$0.001
Goldman Sachs	1,101,174	128,853,451	0.009
UBS Ag	1,046,064	108,623,710	0.010
Morgan Stanley & Co	1,019,941	83,767,202	0.012
Instinet	966,337	98,467,288	0.010
Credit Suisse Bank	950,648	200,919,214	0.005
Saloman Brothers Inc.	738,234	97,653,246	0.008
J.P. Morgan Securities Ltd	726,379	145,550,396	0.005
Deutsche Bank Securities Corp	713,378	102,200,301	0.007
Lehman Brothers Securities	676,356	63,647,044	0.011
Other Non-US Brokers	5,731,936	5,127,541,873	0.001
Total Commissions on Non-US Equity Transactions	\$15,910,654	9,114,498,421	\$0.002